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APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY FOR AUTHORITY TO CHANGE RATES	**§**	**PUBLIC UTILITY COMMISSION OF TEXAS**

COMMISSION STAFF'S REPLIES TO EXCEPTIONS TO THE PROPOSAL FOR DECISION

Respectfully Submitted,

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COMMISSION STAFF'S REPLIES TO EXCEPTIONS TO THE PROPOSAL FOR DECISION

I. INTRODUCTION

Many of the conclusions reached in the Proposal for Decision (PFD) are correct and should be maintained over the objections of Southwestern Electric Power Company (SWEPCO or the Company). The Staff (Staff) of the Public Utility Commission of Texas (Commission) remains grateful for the reasoned consideration of the Administrative Law Judges (ALJs), and Staff supports the PFD's recommendations on the accounting treatment for Dolet Hills and the exclusion of the Net Operating Loss Carryforward (NOLC) Accumulated Deferred Federal Income Tax (ADFIT).

In addition, Staff responds to parties' exceptions regarding the recommended return on equity (ROE) and revenue distribution. While Staff excepted to the PFD on these issues, Staff highlights below that other parties' exceptions on these issues only serve to emphasize the positive qualities of Staff's positions.

Finally, Staff responds below to parties' exceptions on several additional issues.

V. RATE BASE/INVESTED CAPITAL

A. Transmission, Distribution, and Generation Capital Investment

1. Retired Gas-Fired Generating Units

SWEPCO takes issue with the PFD's recommendation with respect to the retirement of five gas-fired generation units:

> **SWEPCO exception: The PFD has taken too restrictive of a view of the Commission's authority to provide a utility with just and reasonable cost recovery for a retired generating unit with undepreciated value.**

PURA[1] § 36.051 is clear and unambiguous. A utility's rates must permit the utility a reasonable opportunity to earn a reasonable return on its invested capital *used and useful in providing service to the public* [emphasis added]. There is no range of restrictiveness on the Commission's authority within this section of the statute. The PFD in this proceeding cites the PFD in Docket No. 46449, which noted that:

> The plain meaning of "useful" is: being of use or service; serving some purpose; advantageous; of practical use, as for doing work, producing material results; supplying common needs. A retired plant does none of these things.[2]

Unlike rules, for which the Commission has the ability to recognize exceptions for good cause or special circumstances, the statute is not discretionary or elective. The PFD correctly applies the statute with respect to these units which are no longer used and useful.

2. Dolet Hills Power Station Retirement

SWEPCO excepts to the PFD's recommendations with respect to the impending retirement of its Dolet Hills Power Station. SWEPCO's exceptions repeat arguments made in its initial and reply briefs. Staff will not respond again to those arguments as the PFD has already provided Staff's position on those. Staff will instead focus its replies herein on two of SWEPCO's exceptions related to the PFD's recommendations regarding the retirement of Dolet Hills.

SWEPCO exception: The PFD would have the Commission violate a clear and meaningful provision of its Cost of Service rule by removing SWEPCO's investment in the Dolet Hills plant from the rate base used to set rates in this proceeding.

As noted previously, the Commission may recognize exceptions to its rules for good cause. The PFD recommended that there is good cause for an exception to the timing requirement in the post-test year adjustment rule at 16 Texas Administrative Code (TAC) § 25.231 (c)(2)(F)(iii)(II) and that a post-test-year adjustment should be made to remove Dolet Hills from rate base in light of its retirement.[3] SWEPCO alleges that in doing so "[t]he PFD proposes to remove one investment – SWEPCO's investment in the Dolet Hills plant - from rate

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[1] Public Utility Regulatory Act, Tex. Util. Code Ann. §§ 11.011-66.016 (PURA).

[2] PFD at 21 citing *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Proposal for Decision at 93-94 (Sep. 22, 2017).

[3] PFD at 52.

base 21 months after the close of the historical Test Year without recognizing any of the additions to rate base that have been and will be made over that same 21 months."[4] SWEPCO goes on to say that penalizing SWEPCO by removing costs associated with the Dolet Hills plant from rates after its retirement without accounting for additional investment placed into service through that same date is arbitrary and one-sided.[5] SWEPCO further complains that the PFD's recommendation would destroy the symmetry the Commission built into the Cost of Service rule for post-test year adjustments to rate base and that it will change that rule to allow a post-test year adjustment for rate base decreases when a plant is expected to retire sometime while the rates will be in effect.[6] Staff notes that SWEPCO denies that the timing of its filing of this case was so that Dolet Hills would be operating during a portion of the rate year and claims that the timing was merely a function of the Company's inability to earn a reasonable return in excess of operating costs.[7]

With respect to the symmetry issue raised by SWEPCO, an important consideration is that the post-test year adjustment portion of 16 TAC § 25.231 was adopted well before the various interim recovery mechanisms for plant additions such as the transmission cost recovery factor (TCRF), the distribution cost recovery factor (DCRF), and the generation cost recovery rider (GCRR) were put in place to reduce regulatory lag by allowing utilities to begin recovering plant investment between major rate cases. When taken as a whole, the addition of these interim recovery mechanisms to the substantive rules obviate the symmetry included in the original post-test year adjustment rule. Additionally, regarding SWECO's claims that it is unable to earn a reasonable return, and its claims that for the period March 21, 2020 (end of test year) through March 31, 2021 it has added $244 million of gross plant,[8] the Company can avail itself of these interim mechanisms to update its invested capital subsequent to the test year end in this case.

SWEPCO continues to make the incorrect claim that the Commission's cost of service rule requires the undepreciated value of Dolet Hills (in excess of $100 million) be depreciated by

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[4] Southwestern Electric Power Companies Exceptions to the Proposal for Decision (SWEPCO's Exceptions to PFD) at 14 (Oct. 7, 2021).

[5] *Id.* at 15.

[6] *Id.*

[7] Tr. at 70-71.

[8] *Id.*

the end of December 2021 as that is the end of its service life.[9] SWEPCO also claims that because it realizes that this would have a significant impact on base rates, it offers two mitigation measures.[10] First, SWEPCO offers to use money owed to the ratepayers because of the federal income tax rate reduction in 2018 to offset the undepreciated value of Dolet Hills and then offers to stretch the remaining recovery over four years because, according to SWEPCO, without this mitigation, it would be depreciated only through the end of 2021."[11]

First, with respect to depreciation expense, 16 TAC § 25.231(b)(1)(B) states: "[d]epreciation expense based on original cost and computed on a straight-line basis as approved by the commission. Other methods of depreciation may be used when it is determined that such depreciation methodology is a more equitable means of recovering the cost of the plant." Contrary to SWEPCO's assertion, there is no requirement that Dolet Hills be recovered by the end of 2021 because the rule allows for other more equitable means for recovering the cost of plants. The PFD recommends that a more equitable means for SWEPCO to recover the cost of Dolet Hills in accord with its useful life ending in 2046, consistent with the precedent established in Docket No. 46449.[12]

Second, SWEPCO is proposing to use ratepayers' own money (that SWEPCO owes them because of the lowering of the tax rate) to offset the undepreciated balance of Dolet Hills. The ALJs correctly recognized that this would be at odds with and essentially reverse the recommendation that the costs of Dolet Hills be recovered through 2046 because it would achieve the "contrary result" of SWEPCO's immediate recovery of most of the Dolet Hills remaining net book value[13] (over $111 million on a total company basis).[14] The tax law change was effective over three years ago. It is time for SWEPCO's ratepayers benefit from the excess accumulated deferred federal income tax (ADFIT) owed to them rather than allowing SWEPCO to use those funds to immediately recover its Dolet Hills costs. SWEPCO's "offers" with regard to its proposed mitigation measures benefit SWEPCO to the detriment of ratepayers.

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[9] SWEPCO's Exceptions to PFD at 16.

[10] *Id.*

[11] *Id.* at 17-18.

[12] PFD at 56.

[13] *Id.*

[14] SWEPCO Ex. 36 at Exhibit MAB 2R "Excess ADIT Off-Set" of $111,311,565.

SWEPCO exception: Even if the Commission were to adopt the PFD regarding the rate treatment of the Dolet Hills Plant, there are errors in the number running implementation of that recommendation.

SWEPCO requests that if the Commission determines that the undepreciated value of the Dolet Hills plant should be removed from rate base and placed in a rider, specific identified errors in the structure of the rider and base rates should be corrected.[15] Staff agrees with most of SWEPCO's points on this issue and notes that due to the prohibition against ex-parte communications, the Staff's internal number running guidelines require that Staff may not inform the decision makers through number running communications of any perceived errors or omissions or offer opinions or suggestions to the decision makers during the number running process. With respect to each error identified by SWEPCO:

1. Staff agrees with SWEPCO that it is appropriate to remove all cost recovery for Dolet Hills from base rates and address cost recovery in the Dolet Hills rider. Staff agrees that the =ADFIT and materials and supplies associated with Dolet Hills that were not removed from base rates should be accounted for in the rider.
2. While not agreeing that it is appropriate for estimated costs to be recovered or earning a return prior to being incurred, Staff does agree that estimated demolition costs are not included in the Dolet Hills rider as calculated by Staff as there was no explicit number running instruction to include them. If it is the ALJ and/or Commission's intention that these costs earn a return and are recovered prior to the costs being incurred, that amount would need to be added to the Dolet Hills rider as suggested by SWEPCO. Staff notes that the Dolet Hills net book value used in the number runs was the net book value of $121,384,897 provided by SWEPCO in response to OPUC 9-1. That figure does not include the estimated demolition costs. However, if the $122,794,917 net book value shown on Exhibit MAB-2R is to be used as suggested by SWEPCO in its exceptions, the estimated demolition costs are already included in that amount in the line labeled as "Demo Estimate" with the amount of $10,740,383.[16] In that case, only the $3,733,171 of materials and supplies would

[15] SWEPCO's Exceptions to PFD at 19.

[16] Staff believes the discrepancy between the net book values is because the $121,384,897 balance used by Staff is the March 31, 2020 test-year end net book value provided by SWEPCO and the $122,794,917 net book

need to be added to the $122,794,917 net book value as shown on MAB-2R to reach the total recoverable amount of $126,528,088 (as opposed to the $137,268,471 amount suggested by SWEPCO). Subtracting the $25,786,933 Dolet Hills ADFIT amount from the $126,528,088 recoverable amount would yield a return net book value of $100,741,155 instead of SWEPCO's calculated amount of $128,057,719.[17]

3. Staff disagrees that the Oxbow investment should be removed from the Dolet Hills rider. Once the plant is retired, there will be no more reconcilable fuel costs connected with the plant. At that point, the Oxbow investment is more appropriately recovered in the Dolet Hills rider with all of the other associated costs as opposed to recovering it through fuel expense.
4. Staff agrees that the Dolet Hills rider tariff will need a true-up mechanism.
5. Staff maintains that there should be no carrying costs on the Dolet Hills Rider. This is not an error in the number running implementation of the rider. It is a legal and policy decision, and the Commission should adopt the PFD recommendation on this issue for all the reasons discussed in Staff's initial[18] and reply briefs.[19]

Staff notes that it has traditionally worked with representatives of SWEPCO in past rate cases to ensure that the final order number runs correctly reflect the Commission's decisions on each issue and anticipates continuing that practice in this proceeding.

C. Accumulated Deferred Federal Income Taxes

1. NOLC ADFIT

SWEPCO's requested treatment of its NOLC ADFIT in this case is a radical departure from how the Commission has traditionally set rates (including how SWEPCO's current rates were set) that could have far- reaching implications for ratemaking in Texas if adopted. The

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value shown on Exhibit MAB-2R is the value at a later point in time and inclusive of the $10,740,383 of estimated demolition costs.

[17] There appears to be a calculation error at SWEPCO's Footnote No. 60: $137,268,471 NBV - $25,786,933 ADFIT = $111,481,538 (not $128,057,719 as shown as the return net book value in the footnote).

[18] Commission Staff's Initial Brief (Jun. 17, 2021).

[19] Commission Staff's Reply Brief (Jul. 1, 2021) (Staff's Reply Brief).

ALJs provide a thoughtful and well-reasoned analysis of the NOLC ADFIT issue and Staff urges the Commission to adopt the PFD. SWEPCO's request to add $455 million to its rate base for a theoretical NOLC that customers would have to foot the bill for. Thankfully the ALJs recognize SWEPCO's request is not based in any proper accounting method and have rejected SWEPCO's request. SWEPCO summarized its exceptions to the PFD on this issue into four basic exceptions.[20] Staff addresses each individually, below.

SWEPCO Exception: The PFD erroneously recommends removal of the Company's stand-alone net operating loss carryforward (NOLC) related to accumulated deferred federal income taxes (ADFIT) from the rate base calculation

There is no dispute between Staff and SWEPCO that the Company incurred stand-alone net taxable losses for the years 2009 through March 31, 2020 that resulted in SWEPCO recording approximately $455 million of stand-alone NOLC ADFIT assets on its books during that period. There is likewise no dispute that SWEPCO received approximately $455 million in cash payments from its affiliates' use of SWEPCO's stand-alone losses on the AEP consolidated tax return. There is also no dispute that, as a result of those cash payments, the actual balance of the stand-alone NOLC ADFIT asset recorded on SWEPCO's books and records kept in accordance with Generally Accepted Accounting Principles (GAAP) and the FERC uniform system of accounts at the end of the test year was $0.

SWEPCO's claim that "[t]he PFD erroneously recommends **removal** of the Company's stand-alone net operating loss carryforward . . .from the rate base calculation"[21] is therefore misleading. The result of the PFD's recommendation is that the balance of the NOLC ADFIT should be $0 which is the same as SWEPCO's **actual** books and records. SWEPCO is attempting to **add** the $455 million back to its rate base and the PFD correctly rejects this ploy. SWEPCO is asking its customers to pay an additional amount of return and associated taxes

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[20] SWEPCO's Exceptions to PFD at 2.

[21] *Id.*

equivalent to what it would pay on a power plant for an asset for which it has already been fully compensated and therefore has been removed from its actual books.[22]

Double counting

SWEPCO states that its proposal does not result in a double-counting of the NOLC as stated in the PFD.[23] SWEPCO claims that "[t]here is no evidence in the record to support such a conclusion because no item of rate base was included in rate base twice."[24] Staff did not contend that the NOLC was included in rate base twice – only that the same $455 million was included twice under SWEPCO's proposal.[25] SWEPCO also claims that Staff is confusing rate base with cash used to pay for rate base and that cash is not plant, property and equipment.[26] Staff is not confusing cash used to pay for rate base with rate base. SWEPCO admits it used the $455 million of funds received from the tax allocation payments of its affiliates to finance prudent invested capital included in its rate base:

> To the extent that the Company received cash through its tax allocation agreement, the Company would not use that additional capital to build plant beyond what would be prudent in serving its customers. Instead, the cash received by the Company through the tax allocation agreement would reduce the otherwise needed capital to fund those prudent investments. As a result, the Company would need less capital through debt and equity than it would have absent the cash received through the tax allocation agreement.[27]

Staff's point is that by having these $455 million of assets financed by the cash payments that SWEPCO received from its affiliates for the NOLC included in rate base and then adding back the $455 million NOLC to SWEPCO's rate base results in SWEPCO earning a return on the same $455 million twice.[28] Therefore, Staff does not claim that the NOLC is in rate base twice, only that the same $455 is double counted under SWEPCO's proposal. Staff's position is that there are assets financed by the tax allocation payments in rate base, not that the tax allocation payments themselves are in rate base.

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[22] Staff Ex. 3 at 40:20-22.

[23] SWEPCO's Exceptions to PFD at 27.

[24] *Id.*

[25] Tr. at 393:23-24.

[26] SWEPCO's Exceptions to PFD at 26- 27.

[27] SWEPCO Ex. 45 at 14:17 – 15:5.

[28] Tr. at 394:18-19.

The Company claims in its exceptions that "SWEPCO may have used the cash payments instead of debt or equity infusions from its parent, but the ultimate rate base balance was not increased beyond was prudent for SWEPCO to provide service."[29] Nowhere does Staff contend that SWEPCO used the tax allocation payments to increase rate base beyond what was prudent. SWEPCO further argues that "[i]f there were no cash payments, SWEPCO would have been required to get that money from some other source (*i.e.* debt and equity)." In the end, the cash allocation payments are no different than an equity infusion from SWEPCO's parent for which the equity investor should be compensated with an applicable return."[30] Except this was not an equity infusion from SWEPCO's parent by its own admission quoted above. It was payment from its affiliates and those affiliates have already been compensated for that cash payment by using SWEPCO's NOLC to avoid paying taxes to the IRS.[31]

SWEPCO claims in its exceptions that the rebuttal testimony of Mr. Hodgson shows that SWEPCO's approach in this case would have the same impact on rates as a similarly situated utility with no tax allocation agreement and no cash payments and that Staff's proposal and the PFD would result in a decrease in SWEPCO's return on rate base.[32] Mr. Hodgson's examples do not show either of these things as demonstrated in Staff's reply brief.[33] Staff's example shows the books and records after receipt of cash for the NOLC under the tax sharing agreement and the use of that cash to finance additional plant assets whereby the NOLC is essentially exchanged for additional plant assets.[34] The total rate base amount is the same before and after the tax allocation payment and the financing of plant assets with that cash in that instance results in no double-counting of the deferred tax asset.[35] Contrary to SWEPCO's assertion, the consolidated tax return and tax allocation agreement therefore have no impact on rate base when

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[29] SWEPCO's Exceptions to PFD at 28.

[30] *Id.* at 29.

[31] Staff Ex. 3 at 41:5-9.

[32] SWEPCO's Exceptions to PFD at 29.

[33] Staff's Reply Brief at 13-16.

[34] *Id.* at 13-14

[35] *Id.*

using the **actual** books and records of SWEPCO to set rates as has been done in SWEPCO's prior rate cases and as proposed by Staff and the PFD in this case.[36]

As Staff witness Ms. Stark testified, debits equal credits and the balance sheet balances but SWEPCO's proposal throws off the ratemaking balance sheet by only adding the NOLC deferred tax assed (DTA) back to rate base (the debit) without reflecting the offsetting credit.[37] This is shown in Staff's reply brief at pages 15-16 which expands on the examples provided in Mr. Hodgson's rebuttal testimony and Table 1 in Staff's reply brief at 13, referenced above.

Additionally, SWEPCO's selectiveness in cherry-picking only this one item to reflect in the theoretical stand-alone calculation is made clear by reviewing the "Regulatory Ratemaking Journal Entries" that SWEPCO supposedly used to add the NOLC ADFIT to its test-year end book balances.[38]

Description	Debit	Credit	2020 Base Case Impact
Def. Tax Asset NOL	$486,133,877		Tax Dept to Include DTA NOL in Rate Base
Debt/Equity		$486,133,877	
Entry to reflect total company NOL as of 12-31-17			
Def Tax Asset NOL	$31,011,387		Tax Dept to Include DTA NOL in Rate Base
Debt/Equity		$31,011,387	
Entry to recognize NOL utilized 2018 thru end of test period activity			

As demonstrated by these journal entries, SWEPCO acknowledges that debits must equal credits and that adding the net debit amount of $455,122,590 to rate base would entail an offsetting adjustment (credit) to something else for the same amount (SWEPCO's proposal is to "Debt/Equity").[39] However, as shown in the column labeled "2020 Base Case Impact" the Company only chose to reflect the net debit amount for the NOLC that increased its rate base balance.[40] Schedule K-1, which presents SWEPCO's actual and proposed capital structure (debt and equity), does not show any such adjustments and Ms. Hawkins, the SWEPCO witness responsible for sponsoring its proposed capital structure (debt and equity) in this proceeding,

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[36] Tr. at 420:24 – 421:3.

[37] Tr. at 420:12-16.

[38] SWEPCO Ex. 1 at WP B-1.5.17 (Dolet ADFIT Offset), tab titled "NOL Excess Entries" JE Nos. 1 and 3.

[39] *Id.*

[40] *Id.*

admitted that she was not familiar with these journal entries[41] and testified that putting the NOLC ADFIT back into rate base does not create debt and equity.[42]

Ms. Stark testified that under SWEPCO's approach and interpretation of a stand-alone tax calculation, the correct offsetting entry to reflect the NOLC ADFIT in rate base is to remove the assets that were financed with the proceeds from the NOLC ADFIT[43] and that SWEPCO should not be able to recognize one part of the entry without recognizing the other because the NOLC ADFIT and the assets financed with the cash SWEPCO received for the NOLC ADFIT are connected.[44] In other words, SWEPCO's proposal throws its regulated balance sheet out of balance by only reflecting the debits that increase invested capital without reflecting any offsetting credits.

Regardless of whether the offset is to a cost free capital account or to the assets financed by the $455 million tax allocation payment, the Company's claim that "SWEPCO's proposal would result in the same return on rate base as a company with no tax allocation agreement and no resulting cash payments."[45] is simply not true as explained above. SWEPCO would have the Commission believe that letting it add back the $455 million to its rate base balance will put it in the same place as other utilities that don't participate in a consolidated tax return and tax sharing arrangement. Clearly a utility that receives $455 million in cash payments that it uses to invest in rate base items without having to incur debt or raise additional equity capital to fund those projects is not in the same financial situation as a utility that has to raise $455 million of capital through borrowing and equity.

SWEPCO justifies its proposed addition of $455 million to its rate base by claiming that "the NOLC still exists on a stand-alone basis for future ratemaking purposes." [46] and that " . . . the NOLC will absorb and reduce current taxes in future periods until the NOLC is reduced to zero on a stand-alone basis."[47] SWEPCO also claimed in its application that its adjustment

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[41] Tr. at 967:11-13.

[42] Tr. at 968:22-25.

[43] Tr. at 420:18-23.

[44] Tr. at 420:10-16.

[45] SWEPCO's Exceptions to PFD at 29.

[46] *Id.* at 30.

[47] *Id.*

"represents the amount of ADFIT associated with accelerated tax depreciation which has not been able to produce cash benefits to the company on the basis of a separate tax return method as of the end of the historic test year."[48] Both of these are theoretical arguments that may sound reasonable on paper, but they are not realistic under further scrutiny. The reality is that SWEPCO already got $455 million of cash benefits for the use of its tax losses and that $455 million payment for the NOLC is the only cash benefit SWEPCO will **actually** receive for those tax losses. As Ms. Stark testified, SWEPCO has already been made economically whole for the NOLC.[49] Theoretical future cash benefits are not actual cash benefits that can be used to finance future operations. The additional capital and equity that SWEPCO claims it avoided having to raise because of the $455 million it received from its affiliates is in reality no longer out there available as a future cash benefit. SWEPCO has not explained how it will use "theoretical" stand-alone cash benefits to protect ratepayers from future actual capital costs based on the company not having actual cash benefits available.

SWEPCO Exception: The PFD recommendation, if adopted, effectuates a consolidated tax adjustment, which is prohibited by PURA § 36.060

Consolidated tax savings adjustment

SWEPCO claims that the PFD violates PURA § 36.060 by including a consolidated tax benefit in the calculation of SWEPCO's cost of service.[50] SWEPCO is incorrect in this assertion. While PURA § 36.060 was amended to address the Commission's interpretation of the previous statute with respect to consolidated tax returns and adjustments, aside from the title of the section "Consolidated Income Tax Returns," the statute itself does not address consolidated tax returns or stand-alone tax returns. The plain wording of the statute does not preclude the reflection of real financial transactions with real economic consequences in rates whether such transactions are the result of a consolidated tax return or not.

As explained by the PFD, the Commission's interpretation of the previous statute involved a mathematically imputed consolidated tax adjustment. The prior version of PURA § 36.060, as interpreted by the Commission, imputed a consolidated tax savings adjustment to

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[48] SWEPCO Ex. 17 at 27:14-17.

[49] Staff Ex. 3 at 40:6-10.

[50] SWEPCO's Exceptions to PFD at 30.

utilities that was not based on any actual transaction between the utilities and their affiliates but was merely a mathematical calculation.[51] It is this type of adjustment that PURA § 36.060 was amended to exclude. In this case, SWEPCO makes a mathematical calculation of what it alleges its theoretical NOLC would be if it were not a member of the AEP, Inc. consolidated tax group and had not actually received $455 million from its affiliates that it used to finance assets in rate base. SWEPCO then makes an adjustment to impute this cherry-picked $455 million back into its rate base.[52] It is SWEPCO that is attempting to do what PURA § 36.060 was designed to prevent. Except in this case SWEPCO is using a consolidated tax adjustment in an attempt to increase rather than decrease its rates.

PURA § 36.060 states in part:

> (a) If an expense is allowed to be included in a utility's rates or an investment is included in the utility rate base, the related income tax benefit must be included in the computation of income tax expense to reduce the rates. If an expense is not allowed to be included in rates or an investment is not included in the utility rate base, the related income tax benefit may not be included in the computation of income tax expense to reduce the rates.

This provision of PURA applies equally to both the assets that caused the tax net operating losses that SWEPCO is singularly focusing on and equally to the assets that were financed by the $455 million that SWEPCO received from its affiliates for those net operating losses. SWEPCO's proposal ignores the application of this section of PURA to the latter category of assets. The PFD interpretation is consistent with PURA § 36.060. SWEPCO properly recorded its NOLCs on its books as they occurred on a separate return basis for the assets that generated the accelerated depreciation that created the NOLCs. Then SWEPCO received $455 million from its affiliates for those NOLC assets that reduced its NOLC balance to $0. By SWEPCO's own admission, it used those funds to invest in other assets that are also included in its rate base. The proper interpretation of PURA § 36.060 is that if the assets financed by the tax allocation payments are included in rate base, then the full amount of the ADFIT tax benefit is reflected on SWEPCO's actual books (not reduced by the NOLC for which

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[51] *Application of Central Power & Light Company for Authority to Change Rates*, Docket No. 14965, Second Order on Rehearing at Finding of Fact No. 112B (Oct. 16, 1997).

[52] Tr. 394:8-21.

SWEPCO received the $455 million) must be used to reduce rates because receipt of the $455 million received from affiliates used to finance those assets reduced the NOLC balance to $0. If those assets are included in rate base, then this related tax benefit (the ADFIT not reduced by the NOLC) must be included to reduce the rates.

PURA § 36.060 does not exist in a vacuum and must be harmonized with other relevant sections of the statute. One such section, PURA § 36.059, states in part:

> (a) In determining the allocation of tax savings derived from liberalized depreciation and amortization, the investment tax credit, and the application of similar methods, the regulatory authority shall:
>
> (1) balance equitably the interests of present and future customers; and
>
> (2) apportion accordingly the benefits between consumers and the electric or municipally owned utility.

The PFD treatment of the NOLC is also consistent with this section of PURA. Because the NOLC was derived from liberalized depreciation, using SWEPCO's actual GAAP and FERC books – that is, recognizing a $0 balance for the NOLC because SWEPCO has assets in rate base that were financed with the cash SWEPCO received for the NOLC - equitably apportions the benefits between customers and the utility. As Ms. Stark testified, SWEPCO got the benefit of $455 million in cash from its affiliates that it used to invest in assets included in rate base. SWEPCO's affiliates benefitted by using the NOLC to avoid paying the IRS $455 million so SWEPCO's ratepayers do not owe a return on the NOLC.[53]

SWEPCO claims that the PFD ignores the stand-alone tax calculation requirements of PURA § 36.060 by eliminating one component (the NOLC) from SWEPCO's stand-alone calculation.[54] As explained previously, SWEPCO already calculated its taxes on a stand-alone basis when it initially recorded the $455 million NOLC on its GAAP and FERC books. SWEPCO itself eliminated the NOLC ADFIT from its actual books and records when it accepted $455 million of tax allocation payments from its affiliates for their use of them to offset their own taxable income. The PFD does not propose to remove the NOLC ADFIT – it proposes that SWEPCO not be allowed to add back to its rate base an asset for which it already received full compensation.

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[53] Staff Ex. 3 at 41:5-9.

[54] SWEPCO's Exceptions to PFD at 30.

SWEPCO also quotes the PFD which states "SWEPCO and Staff agree, at least in concept, that SWEPCO is required to calculate its income-tax expense (including ADFIT) on a stand-alone basis – *i.e.*, reflecting only SWECO's own benefits and burdens in providing service to its customers, without comingling any tax benefit obtained by its affiliates."[55] Staff agrees that it is not the participation in the consolidated tax return and tax allocation agreement that it takes issue with, rather, it is that SWEPCO only wants to selectively reflect one consequence of a theoretical stand-alone calculation to reflect in its rates as explained above.[56]

SWEPCO argues that "The PFD's recommendation to remove SWEPCO's stand-alone NOLC ADFIT from rate base simply because of the tax allocation payments results in "comingling . . . tax benefits obtained by its affiliates."[57] It is SWEPCO that is attempting the comingling of tax benefits of its affiliates into its cost of service. Using cash received from its affiliates for the use of SWEPCO's NOLC in the consolidated tax return to finance assets for which it seeks to earn a return from ratepayers while also claiming the NOLC as an asset in rate base undeniably comingles tax benefits of SWEPCO's affiliates into its cost of service. SWEPCO also claims that the PFD incorrectly concludes that the tax allocation payments somehow contaminate a portion of rate base.[58] Again, to the extent that SWEPCO used the tax allocation payments to finance a portion of its rate base, and then wants to add the assets it exchanged for those tax allocation payments back to its rate base, the PFD is correct.

Staff's proposal (as adopted by the PFD) is to use SWEPCO's actual books and records that are kept in accordance with GAAP and FERC accounting requirements and is consistent with how the Commission has traditionally set rates and how SWEPCO's current rates were set. Doing so is consistent with PURA §§ 36.059 and 36.060 and does not recognize a consolidated tax benefit as shown in the examples provided in Staff's reply brief.[59] The result of the PFD reflects the results of SWEPCO's actual operations based on actual financial payments from its affiliates that have real economic substance and consequence. That substance and consequence is that SWEPCO received $455 million from its affiliates for the use of its NOLC that it

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[55] SWEPCO's Exceptions to PFD at 26, quoting the PFD at 80.

[56] Tr. at 394:8-10.

[57] SWEPCO's Exceptions to PFD at 29.

[58] *Id.*, quoting PFD at 80.

[59] Staff's Reply Brief at 13-16.

otherwise would have had to borrow or raise equity capital. By SWEPCO's own admission it used the $455 million that was not debt or equity to finance assets that are included in its requested rate base on which it seeks a debt and equity return from ratepayers. SWEPCO wants the Commission to ignore real economic transactions with real economic consequences. It is SWEPCO that is seeking to make a consolidated tax adjustment in this case. Under SWEPCO's interpretation of PURA § 36.060 and its new proposed interpretation of the theoretical stand-alone methodology (presented in this case for the first time), its rate base goes up $455 million above what is recorded on its actual books recorded under GAAP and FERC accounting just because of the filing of the consolidated tax return and for no other reason.[60] It is the Company's own proposed methodology would include an improper consolidated tax benefit to SWEPCO.

SWEPCO Exception: The PFD recommendation, if adopted, would further cause a violation of the Internal Revenue Service's normalization requirements

Normalization

SWEPCO claims that use of its actual books and records, kept in accordance with GAAP and the FERC uniform system of accounts for setting its rates in this proceeding puts it at risk of a normalization violation. According to SWEPCO, "[d]uring the preparation for this filing, the Company identified risks associated with using the GAAP balance of ADFIT for ratemaking purposes."[61]

SWEPCO claims that "[b]y denying SWEPCO's NOLC ADFIT adjustment, the PFD recommends that SWEPCO's ADFIT not be calculated on a stand-alone basis even though many IRS rulings provide otherwise."[62] First, as discussed in previous sections, the PFD does not recommend that SWEPCO's ADFIT not be calculated on a stand-alone basis. As explained previously, SWEPCO's GAAP and FERC accounting records already reflect a stand-along approach. The PFD recommendation is not that SWEPCO's ADFIT should not be calculated on a stand-alone basis. The PFD recommendation is based on SWEPCO's actual GAAP and FERC

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[60] Tr. at 394:14-21.

[61] Staff Ex. 3 at Attachment RS-40.

[62] SWEPCO's Exceptions to PFD at 31 citing SWEPCO Ex. 17 at DAH-1 through Exhibit DAH-7 and SWEPCO Ex. 44 at Exhibit BMS-1R and Exhibit BMS-2R.

accounting stand-alone tax calculations that were modified by SWEPCO through its receipt of cash payments for its NOLC.

The "many IRS rulings" provided by the Company do not support SWEPCO's case.[63] In fact, in one specific PLR provided by SWEPCO, the IRS allowed recognition of a reduction to NOLC ADFIT due to a tax allocation agreement payment, only requiring that it be treated in a manner consistent with other elements of rate base.[64] This PLR notes that an audit of the consolidated tax returns of the consolidated group of which the utility was a member resulted in adjustments to the taxable income of both regulated and non-regulated members of the group.[65] The IRS and the consolidated group entered into a settlement agreement that absorbed a portion of the consolidated NOLC attributable to the utility and the utility received payments from the group under its tax sharing agreement for the use of its NOLC.[66] These results were recorded on the utility's books "in the appropriate DTA accounts."[67] According to the PLR, "The recordation resulted in a reduction in Taxpayer's NOLC-related DTA. By reducing Taxpayer's DTA, this recordation increased Taxpayer's net ADFIT balance."[68] The IRS refers to this result as "the impact of the IRS Settlement" in its analysis and conclusion in the PLR.

Subsequent to the recordation of the adjustments to the NOLC ADFIT (DTA) balance due to the payments received under the tax sharing agreement, the utility filed rate cases in two of the state jurisdictions in which it operates.[69] The recordation of the reduction to the NOLC ADFIT (DTA) occurred in the last month of the test period used for the case in the first state[70] and in the fourth month prior to the end of the test period in the second state.[71] Both states employ a 13-month average to compute rate base and the utility proposed including 1/13 and 4/13, respectively, of the reduction to its NOLC deferred tax asset balance (the impact of the IRS

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[63] Staff's Initial Brief at 22-28.

[64] IRS PLR 201828010, SWEPCO Ex. 44 at Exhibit BMS-2R.

[65] *Id.* at 4.

[66] *Id.*

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.* at 5

settlement) in determining its requested rate base.[72] Intervening parties in both states proposed to reflect the full amount (end of test period amount) of the reduction (impact of the IRS settlement) in rate base.[73] Thus, the question before the IRS in that PLR was:

> Whether the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is acceptable under the Normalization Rules.[74]

The IRS notes in its analysis that "[i]n order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the procedures and adjustments used in ratemaking to calculate elements in rate base, depreciation expense, tax expense, and the reserve for deferred taxes."[75] The IRS further explains that "[i]n this case, the IRS settlement has an effect on Taxpayer's ADFIT balance and the Taxpayer, along with Commission A and Commission B, agree that the settlement must be taken into account in setting Taxpayer's rates."[76] The IRS explained that "the only question is whether the same convention used to calculate other elements of rate base, including ADFIT, a 13-month averaging convention, must also apply to calculate the effect of the IRS Settlement, or whether a different convention may apply to this element."[77] The IRS concluded that "the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is not acceptable under the Normalization Rules."[78]

The whole point of contention in that PLR was the treatment of the tax sharing payment received by the utility that reduced the NOLC (and therefore increased ADFIT) and how much of that reduction should be reflected in rates. The facts in this PLR are very similar to the facts

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[72] *Id.* at 4-5.

[73] *Id.*

[74] *Id.* at 5.

[75] *Id.* at 6.

[76] *Id.*

[77] *Id.*

[78] *Id.*

in SWEPCO's case – SWEPCO received payments under the tax sharing agreement for the use of its NOLC DTAs and the recordation of these payments were recorded in the appropriate DTA accounts which resulted in the reduction of the NOLC related DTA balance to $0.[79] In noting that the taxpayer and its two different state commissions agreed that the reduction to the NOLC from the tax sharing agreement (the effect of the IRS settlement) should be taken into account in setting rates, the IRS did not say that doing so would be a normalization violation. Surely if it were a normalization violation to reduce the NOLC in rate base by the funds received from the tax sharing agreement the IRS could not and would not simply ignore that and not mention it in its analysis. The IRS did not question the reduction of the NOLC because of the tax sharing payment, only that it was included in rate base at the end-of-period balance as opposed to the 13-month average convention used for the other rate base items. Staff's proposal to include the end of test period balance of the NOLC deferred tax asset balance of zero, consistent with the end of test period balance used for the other elements of SWEPCO's rate base therefore complies with the consistency and normalization provisions of the internal revenue code and is consistent with the IRS's ruling in this PLR.

While the other PLRs provided by SWEPCO in testimony and discovery do not directly address the reduction to the NOLC ADFIT because of a payment under a tax sharing agreement, they nonetheless support Staff's position that reflecting SWEPCO's actual book NOLC ADFIT balance of $0 would not result in a normalization violation. One of particular importance and relevance in this case is PLR No. 201418024 in which the IRS made the following finding:

> Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of

[79] Staff Ex. 3 at 38:3-6.

that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.[80]

The IRS determined in this PLR that because the Commission did not reduce income tax expense included in rates for the NOL, it was not required to include the NOLC asset in rate base. Ms. Stark explained that the depreciation expense used in calculating federal income taxes is the same as that used in setting rates and that the difference between that and the accelerated depreciation used for tax is recorded as ADFIT.[81] Ms. Stark also testified that the total of the current and deferred taxes are included in cost of service.[82] Additionally, Schedule G-7.6 of SWEPCO's application confirms that there is no reduction for a federal net operating loss in SWEPCO's income tax expense calculation that determines the current and deferred taxes included in cost of service.[83] A review of the PUCT's rate filing package for generating utilities like SWEPCO (including the sample Tax Method One and Tax Method Two forms) verifies that there is no requirement for the federal income tax expense to be reduced by any federal net operating loss and therefore the PUCT's tax expense calculation allows utilities to collect amounts from ratepayers equal to income taxes due absent any NOLC, providing for the full difference between accelerated and regulatory depreciation to be included in the tax expense in rates without regard to any NOLC. Inclusion of the actual balance of SWEPCO's NOLC of $0 is therefore consistent with the normalization rules as supported by this PLR.

SWEPCO notes that "[t]he PFD further points out that there is no specific letter ruling directly addressing SWEPCO's fact pattern."[84] This is true even though the normalization requirements have existed for decades and many utilities are members of consolidated groups

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[80] Staff Ex. 23.

[81] Staff Ex. 3 at 30:13-20.

[82] Tr. at 390:6-7.

[83] SWEPCO Ex. 1 at Schedule G-7.6.

[84] SWEPCO's Exceptions to PFD at 31, citing PFD at 90.

that file consolidated tax returns and are subject to the same GAAP and FERC accounting rules as SWEPCO. It is not surprising, however, considering the two PLRs, discussed above both on their own and taken together. If most utility commissions set rates as Texas does - that is include as the provision for deferred taxes the entire difference between accelerated tax and regulatory depreciation even when a utility has a NOL while also allowing the utility to collect from ratepayers the income taxes that would be due absent an NOL, the ADFIT reduction to rate base without consideration of the NOLC is not a normalization violation. It then follows that, as shown in the first PLR discussed above, the IRS has considered how to treat tax allocation payments that reduce NOLC deferred tax assets (thereby increasing ADFIT) without declaring that such reduction violates normalization requirements because under the Texas rate-setting paradigm the ADFIT reduction to rate base absent the NOL is not a normalization violation.

SWEPCO tries through its exceptions to make it seem as if the PFD, by adopting Staff's recommendation, is making some unreasonable adjustment that is a departure from standard ratemaking treatment in Texas. That is not the case. The PFD's recommendation is that the Commission keep the status quo with respect to the treatment of SWEPCO's NOLC. By SWEPCO's own admission, the idea of this potential violation of the normalization requirements and PURA § 36.060 issue just came about for the first time while it was preparing this case.[85] It is SWEPCO that is attempting to change the way that this Commission has set rates for decades. SWEPCO admits that its current rates do not reflect a theoretical stand-alone NOLC.[86] If SWEPCO's current rates potentially run afoul of the normalization requirements, it follows that all Texas utilities that are members of a consolidated group filing a consolidated tax return and have tax allocation agreements for the sharing of tax losses among affiliates and that for years have had rates in place based on their actual GAAP books and records and FERC accounting requirements, could also have rates in place that violate state law and IRS normalization requirements if SWEPCO's assertions and arguments are correct.

SWEPCO Exception: Even if the Commission were inclined to adopt the PFD's recommendation, SWEPCO requests that the Commission protect SWEPCO and its customers from unintended normalization violation.

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[85] SWEPCO Ex. 17 at 19:10-12.

[86] SWEPCO Ex. 45 at 19:7-9.

Private letter ruling

SWEPCO has stated that it intends to seek a private letter ruling on the normalization issue.[87] Staff has conveyed to SWEPCO that it strongly opposes the filing of the PLR prior to the Commission's consideration of this case. First, because there is no Commission order, there has been no delegation to Staff to act on the Commission's behalf with respect to working with SWEPCO to come up with acceptable language for the request or authority for Staff to file a statement of position. Second, and most importantly, SWEPCO filed its case over a year ago and the Commission is set to consider the PFD at its November 18th open meeting. There is no compelling reason that SWEPCO must file the PLR request prior to the Commission's action in this case and doing so would limit the Commissioners' ability to provide direction and input into the PLR and would result in a request before the IRS that lacks all pertinent facts and that does not sufficiently present both sides of the issue. The Commissioners might want to provide guidance to SWEPCO with respect to the PLR that could be especially important given the potential major impact of SWEPCO's request on Texas ratemaking.

For example, in Docket No. 14965, there was a dispute between Central Power and Light Company (CPL) and other parties in the case regarding claimed potential normalization violations. CPL was, at the time, a sister company of SWEPCO and CPL's successor company, AEP Texas, is still a SWEPCO sister company. In that case, the parties reached an agreement as to how the federal income tax normalization issues were to be calculated and, based on this agreement reached by the parties, the Commission ordered the following: [88]

> 3(a) CPL shall petition the Internal Revenue Service (IRS) for a private letter ruling (PLR) for the purpose of determining whether the amortization of investment tax credits (ITC) associated with the invested capital designated as ECOM over the accelerated twenty-year amortization period for ECOM would violate the normalization requirements of the Internal Revenue Code. In applying for the PLR from the IRS, CPL will fully and fairly disclose the circumstances of this request. CPL will set forth the proposal to apply a twenty-year amortization period and will present the

[87] SWEPCO's Exceptions to PFD at 27.

[88] Docket No. 14965, Second Motion on Rehearing at Ordering Paragraph No. 2.

> position that use of a twenty-year amortization period for such ITC is not a normalization violation. CPL will address relevant IRS precedent pertaining to both sides of the issue but will request the IRS to find that no normalization violation occurs applying the twenty-year amortization period to the ITC associated with ECOM. CPL shall coordinate its request for the PLR with General Counsel and OPC in order that they may have an opportunity to file statements of their respective positions. It is further directed that General Counsel and OPC shall have the opportunity to attend any Conference of Right.

At the time this Order was issued, Commission Staff was referred to as General Counsel. As this ordering paragraph shows, the Commission may want to provide specific instructions regarding the process and content of the PLR request.

2. Excess ADFIT

SWEPCO states that ". . . Mr. Hodgson's testimony clearly shows that excluding the NOLC from the excess ADFIT calculation would result in SWEPCO's customers receiving more in excess deferred taxes than they originally paid."[89] Mr. Hodgson's numerical examples and the related discussions at pages 22 through 24 of his rebuttal testimony imply that ratepayers only pay the difference between book and tax depreciation that reduces taxable income to zero and not the full difference between book and tax depreciation because of the net operating loss.[90] However, Staff witness Ms. Stark testified that the total of the current and deferred taxes are included in cost of service and the accumulation of the deferred taxes that would be owed in future years is the ADFIT balance.[91] Additionally, SWEPCO's Schedule G-7.6 confirms that there is no reduction to the current and deferred taxes included in cost of service for a federal tax net operating loss.[92] Therefore, the Commission's tax expense calculation provides for the inclusion of the full difference between accelerated and regulatory depreciation in rates without regard for any net operating loss consistent with PURA § 36.059 and 16 TAC § 25.231(b)(1)(D).

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[89] SWEPCO's Exceptions to PFD at 32 citing SWEPCO Ex. 45 at 21:7-24:13.

[90] SWEPCO Ex. 45 at 22-24.

[91] Tr. at 390:6-11.

[92] SWEPCO Ex. 1 at Schedule G-7.6.

Ms. Stark further testified that ADFIT is often referred to as an interest-free loan from the government because customers have paid for the deferred taxes and the utility has the opportunity to use that money in the interim before they become due in the future.[93] This means that ratepayers paid the full $3,850 in tax expense in cost of service in Mr. Hodgson's numerical example at the top of page 23 of his rebuttal testimony, not the $3,500 that he states that the utility has collected in rates.[94] As explained in Staff's Initial Brief, Mr. Hodgson is confusing the reduction to the ADFIT balance in rate base, and therefore the reduction to the amount of cost-free capital available to SWEPCO, with the actual amount of deferred taxes that ratepayers are required to pay in the federal income tax expense component of rates. The facts above support that ratepayers paid the full amount of the excess ADFIT, and the full amount should be refunded without regard to any theoretical stand-alone net operating loss. As recommended by Staff, SWEPCO's proposed adjustments to reduce the protected excess ADFIT amortization owed to ratepayers by its proposed adjustments related to a stand-alone NOLC should be rejected.[95] Staff urges the Commission to reject SWEPCO's exception based on the facts outlined above.

VI. RATE OF RETURN

A. Return on Equity

Staff agrees with the PFD and SWEPCO that the *Hope*[96] and *Bluefield*[97] decisions set forth the minimum constitutional standard applicable to equity returns for utility investors.[98] That is, a utility is entitled to a reasonable opportunity to earn a return that is commensurate with investments of comparable risk, ensures financial soundness, and attracts capital at reasonable rates.[99] However, Staff disagrees with SWEPCO's assertion that the PFD's recommended ROE

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[93] Tr. at 390:12-20.

[94] SWEPCO Ex. 45 at 12: Table at top of page through 8.

[95] Staff Ex. 3 at 44:4-19.

[96] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[97] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923).

[98] SWEPCO's Exceptions to PFD at 39.

[99] *Id.*

of 9.45%, and, further, Staff's recommended ROE of 9.325% provided in its Exceptions to the PFD,[100] do not meet these standards.

The PFD lays out a reasonable range for the ROE in this proceeding of 9.00% to 9.90%.[101] SWEPCO's proposed 9.00% to 10.20% range[102] is inflated and based on misplaced reliance on average ROE returns for proxy group companies. SWEPCO further contends that a final ROE of 9.60%, the midpoint of its proposed range, "more accurately reflects the accepted analyses of all testifying witnesses."[103] As opposed to SWEPCO's inflated ROE range, the PFD's recommended ROE is in line with the ROE range recommended in Staff witness Mark Filarowicz's Direct Testimony.[104] Mr. Filarowicz's analyses reveal that a range of 9.05% to 9.35% is more appropriate based on both constant growth and multi-stage DCF analyses of comparable proxy group companies and a conventional risk premium analysis.[105] Staff does not object that the 9.45% ROE recommended by the PFD would be appropriate as a base ROE for SWEPCO in this proceeding. As previously noted, Staff continues to recommend a 12.5 basis point adjustment to SWEPCO's ROE for poor vegetation management practices, which would result in a final ROE of 9.325%.[106] An ROE of 9.325% lies at the top of Staff's initial recommended ROE range, consistent with Mr. Filarowicz's Direct Testimony.[107]

In arguing that a 9.45% ROE is not commensurate with the ROEs for companies having comparable risk to SWEPCO, SWEPCO relies on Walmart's average of state-authorized ROEs for the proxy group entities in Mr. Filarowicz's, SWEPCO witness Dylan D'Ascendis', and the intervenors' ROE witnesses Gorman's and Woolridge's proxy groups.[108] While Staff does not dispute that the average authorized ROE of Mr. Filarowicz's proxy group is 9.61%,[109] the

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[100] Staff's Exceptions to PFD at 7.

[101] PFD at 146.

[102] SWEPCO's Exceptions to PFD at 38, 40.

[103] *Id.* at 38.

[104] Staff Ex. 1.

[105] *Id.* at 28.

[106] Staff Exceptions to PFD at 7.

[107] Staff Ex. 1 at 28-29.

[108] SWEPCO's Exceptions to PFD at 39-40.

[109] *Id.* at 40.

average ROE of the proxy group is not the primary consideration on which Staff made its recommendation. Mr. Filarowicz took into account recent trends in authorized ROEs at this Commission and across the country *after* performing both single-stage and multistage DCF analyses.[110] Mr. Filarowicz's analysis of nationwide authorized ROEs led him to recommended using the 75th percentile results from his ROE range but did not improperly inflate his DCF analysis to the level requested by SWEPCO.

In fact, the PFD specifically distinguishes the results of Walmart's state authorized ROE analysis of "no higher than 9.6%" from the rest of the parties' analyses on the basis that it "was based on a review of approved ROEs…*rather than mathematical analysis* [emphasis added]."[111] The PFD correctly recognizes that the mathematical analyses should be given the greater share of the weight in coming to a recommended ROE. Additionally, the ALJs appropriately afforded greater weight to the constant growth analyses in coming to their ROE recommendation, as did Mr. D'Ascendis.[112] Mr. Filarowicz duly performed a DCF analysis, along with a risk-premium analyses, methodologies which are consistent with Commission precedent, following the selection of his proxy group. While Mr. D'Ascendis used inputs and methodologies that are not regularly utilized at this Commission, Mr. Filarowicz used tried and true models, inputs, and calculation methodologies, consistent with Commission precedent. Staff believes that the correct range for SWEPCO's ROE is the range between Mr. Filarowicz's recommended ROE of 9.35% and the PFD's ROE of 9.45%. Further, SWEPCO witness Dylan D'Ascendis' own updated constant growth DCF analysis produced a 9.32% ROE, extremely close to Mr. Filarowicz's DCF result.[113] Staff concurs with the ALJs that the mathematical analyses, including the constant growth DCF analysis, should be given greater weight, and by extension, inform SWEPCO's ROE, in addition to average authorized ROEs for comparable proxy group companies. Doing so will ensure that the ROE will appropriately reflect SWEPCO's risk profile and properly balance the needs of SWEPCO's stakeholders and its ratepayers.

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[110] *See* Staff Ex. 1 at 21:21 – 22:7.

[111] PFD at 145, Footnote 743.

[112] PFD at 146.

[113] SWEPCO Ex. 38 at 32:11-13. The PFD provides that Mr. D'Ascendis' constant growth DCF analysis produced a 9.42% ROE. However, Staff believes this to in error. *See* PFD at 146.

Even if the ALJs were to recommend the inflated ROE of 9.60% as proposed by SWEPCO in its Exceptions, Staff contends that the 12.5 basis point reduction should be applied, which would result in an adjusted ROE of 9.475%. Were a ROE adopted in line with average authorized ROE for all electric utilities of 9.56%, as provided by SWEPCO, the resulting adjusted ROE of 9.435% would be even lower.

In sum, Staff utilized well-established methodologies consistent with Commission precedent. A 9.325% ROE will allow SWEPCO to earn a return that is commensurate with investments of comparable risk, ensures financial soundness, and attracts capital at reasonable rates, in accordance with the standards of *Hope* and *Bluefield*. Further, a 9.325% ROE properly balances the needs of SWEPCO's stakeholders and ratepayers.

VII. EXPENSES

H. Taxes Other than Income Tax

1. Ad Valorem (Property) Tax

With respect to the calculation of the effective ad valorem tax rate, SWEPCO erroneously asserts that Staff made false statements in its initial brief[114] and also incorrectly claims that Staff accused SWEPCO of making Texas-only adjustments that would result in an increase in the effective tax rate.[115] SWEPCO further protests that "[t]he ALJs appear to have overlooked that SWEPCO conclusively disproved this false statement in its reply brief, relying on record evidence."[116] Moreover, SWEPCO requested that Staff correct its "misstatement."[117] The following will show that Staff did not make false allegations or misstatements in its initial brief. In support of its claims, SWEPCO quotes the following passage from Staff's initial brief:

> SWEPCO itself includes Texas jurisdictional differences in the calculation of its effective tax rate that serve to reduce the balance of plant subject to the tax (and therefore increase the effective rate) such as the Texas jurisdictional Turk imprudence disallowance, Texas VM write-offs, and capitalized incentive compensation, among others. SWEPCO, as the party with the burden of proof, has provided no evidence or justification for why it is appropriate to include the Texas

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[114] SWEPCO's Exceptions to PFD at 47.

[115] *Id.* at 49.

[116] *Id.* at 47.

[117] *Id.*

> jurisdictional differences that increase the effective rate while arguing against including Texas jurisdictional differences that decrease the effective rate.[118]

The passage from Staff's initial brief cited above does not say that SWEPCO made adjustments to include Texas jurisdictional differences in the calculation of its effective tax rate that reduce the balance of plant subject to the tax. Staff does not accuse SWEPCO of making any adjustments in the calculation of its effective rate. SWEPCO is reading words into Staff's initial brief that are simply not there. Staff stated the indisputable fact that SWEPCO includes Texas jurisdictional differences in the plant balance used to calculate the effective rate and that inclusion of those amounts serves to increase the effective rate as supported by the following evidence.

First, SWEPCO correctly quoted Staff witness Ms. Stark's explanation of SWEPCO's calculation of the effective tax rate:

> SWEPCO's calculation of its requested ad valorem tax expense begins with an amount of $6,315,734,214 that it identifies as its January 1, 2019 net electric plant subject to ad valorem tax. SWEPCO then indicates that $63,325,856 of ad valorem taxes were paid for the 2019 tax year. SWEPCO divides the $63,325,856 of 2019 ad valorem taxes paid by the $6,315,734,214 plant balance identified by SWEPCO as the January 1, 2019 balance subject to ad valorem tax to determine its effective ad valorem tax rate of 1.00266816%.[119]

SWEPCO goes on to say that "[t]he SWEPCO workpaper cited by Staff in its initial brief disproves Staff's allegation because W/P Schedule A-3.13.1 clearly shows that the calculation of the effective tax rate, shown on lines 1 through 3, is simply the actual 2019 property taxes incurred by SWEPCO divided by the unadjusted rate base, just as described above."[120] SWEPCO is correct that the first three lines of that workpaper show the calculation of the effective rate, including the amount of $6,315,734,214 identified by SWEPCO as " January 1, 2019 Net Electric Plant Subject to Ad Valorem Tax."[121] However, Attachment RS-53 to the testimony of Ms. Stark provides the breakdown of the $6,315,734,214 (the "January 1, 2019 Net Electric Plant Subject to Ad Valorem Tax") that is used as the denominator of the effective rate calculation. This attachment, the response to a Staff discovery request provided by SWEPCO,

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[118] *Id.* at 49, quoting Staff's Initial Brief at 65.

[119] SWEPCO's Exceptions to PFD at 49, quoting Staff Ex. 3 at 48:10-17.

[120] *Id.*

[121] SWEPCO Ex. 1 at W/P Schedule A-3.13.1.

clearly and unequivocally shows negative amounts of invested capital with "TX" used in the description at accounts 1160016 through 1160028 and that such amounts are included in the $6,315,734,214 used as the denominator in the effective tax rate calculation.[122] Additionally, the ($58,411,747.11) balance labeled "OthElecPltAdjTurkImprmnt-EPIS" at account 1160007 is unquestionably a Texas jurisdictional amount based on the following Finding of Fact from the order in Docket No. 46449:

> 74 As a result of exceeding the cost cap ordered in Texas, SWEPCO excluded more than $58 million (Texas retail) of construction cost from its rate base in this proceeding.[123]

Thus, it is a true statement that "SWEPCO itself includes Texas jurisdictional differences in the calculation of its effective tax rate" because the denominator in the calculation includes the Texas jurisdictional amounts identified above. Additionally, the inclusion of these negative amounts mathematically causes the January 1, 2019 balance subject to ad valorem tax to be less than it would be without them and dividing the amount of total taxes paid by a lower denominator mathematically results in a higher effective tax rate. Staff's assertion that "SWEPCO itself includes Texas jurisdictional differences in the calculation of its effective tax rate that serve to reduce the balance of plant subject to tax (and therefore increase the effective rate)" is a true statement and SWEPCO's allegation is therefore wrong with respect to Staff's position in its initial brief.

Furthermore, including additional positive amounts in the January 1, 2019 balance subject to ad valorem tax (the denominator) would mathematically result in a lower effective tax rate. The passage from Staff's initial brief that SWEPCO takes exception to was merely to point out that certain positive Texas jurisdictional amounts that SWEPCO wishes to include as adjustments to rate base subject to ad valorem tax (and apply the effective rate to) also existed at January 1, 2019, but were not included in the calculation of the effective rate.[124] In this passage, Staff was pointing out the inconsistency of SWEPCO excluding these positive Texas jurisdictional differences that also existed at January 1, 2019 from the $6,315,734,214 amount it identified as the "January 1, 2019 balance subject to ad valorem tax" if these differences are in

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[122] Staff Ex. 3 at Attachment RS-53, page 2 of 2 (Bates page 000150).

[123] *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Order on Rehearing at Finding of Fact No. 74 (Mar. 19, 2018).

[124] Staff Ex. 12.

fact subject to the tax, but then applying the effective tax rate to those positive Texas jurisdictional differences to calculate its requested ad valorem tax expense. As Ms. Stark testified:

> Failure to include the January 1, 2019 balance of these items in the calculation of the effective rate while applying the effective rate to the March 31, 2020 balance that includes them does not properly synchronize the effective ad valorem tax rate with the associated property subject to the tax. This results in another mismatch between the calculated effective rate and the assets to which it is applied. Once again, the denominator in the calculation of the effective rate is understated by the January 1, 2019 balances of these items which has the effective of overstating the effective ad valorem tax rate.[125]

SWEPCO claims that "[i]f Texas-only jurisdictional adjustments were made to the 2019 value of property on which the 2019 property taxes were calculated, it would reduce the effective rate for Texas customers below that for Louisiana and Arkansas customers. Neither Staff nor the PFD explain why Texas customers should be charged a lower effective tax rate than customers in Louisiana and Arkansas"[126] SWEPCO answers its own question by admitting that

> "[f]or determining Texas' rate base, SWEPCO's books are adjusted to recognize Texas specific decisions. For example, accumulated depreciation is restated to recognize Texas approved depreciation rates. In this case, Texas depreciation rates over time have been lower than average. Therefore, on a Texas basis, the undepreciated value of SWEPCO's property is higher than in the other two states."[127]

As explained above, a larger denominator (book value or undepreciated value of property) mathematically results in a lower effective rate, so it makes sense that Texas would have a lower effective rate given the higher net book value of its plant. Staff's reply brief presents an example that shows that even with a lower effective tax rate, Texas ratepayers pay their fair share of ad valorem taxes.[128]

SWEPCO also claims that there is no truth to the following finding of fact:[129]

> 180. SWEPCO's requested effective ad valorem tax rate excludes Texas jurisdictional differences that would decrease the effective tax rate but includes Texas jurisdictional differences that increase the effective rate.

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[125] Staff Ex. 3 at 51:3-10.

[126] SWEPCO's Exceptions to PFD at 48.

[127] *Id.*

[128] Staff Reply Brief at 43.

[129] SWEPCO's Exceptions to PFD at 49.

As explained above, the evidence shows that there were positive Texas jurisdictional plant differences that existed on January 1, 2019 that were not included in the calculation of the effective ad valorem tax rate and that there were negative Texas jurisdictional plant differences as of the same time that were included in the calculation of the effective rate. There was nothing untrue in Staff's brief that was relied upon by the ALJs in making their decision in this case. There is likewise nothing untrue in the proposed Finding of Fact No. 180. SWEPCO's exceptions as well as its proposed replacements for Findings of Fact Nos. 180-184 should be rejected.

VIII. BILLING DETERMINANTS

B. ETSWD's Proposed COVID-19 Adjustment

The PFD correctly concludes that SWEPCO should not be required to update its customer class cost of service study (CCOSS) to incorporate the economic impacts of the COVID-19 pandemic.[130] In its exceptions, ETSWD claims that the PFD incorrectly labels its recommendation to adjust SWEPCO's CCOSS to reflect load changes due to the COVID-19 pandemic as speculative and ETSWD states that their recommendation comports with the Commission's known and measurable standard.[131] However, as explained in Staff's initial brief, ETSWD's proposal does not meet the Commission's known and measurable standard because it is not reasonably quantifiable and does not describe a situation that is apt to prevail in the future.[132] It is difficult to fully measure the impact of COVID-19 on SWEPCO's Texas retail sales and "updating SWEPCO's cost of service study would not result in rates that are known to be reflective of customer demands going forward."[133]

Additionally, as Staff states in its initial brief, ETSWD did not provide the information necessary to make their proposed adjustment for each of the nineteen different classes included in SWEPCO's CCOSS.[134] Therefore, it is not possible to implement this adjustment since the needed data is not in the record in this case. As the PFD explains, if ETSWD's proposed

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[130] PFD at 265.

[131] East Texas Salt Water Disposal Company Exceptions at 3-4 (Sept. 13, 2021) (ETSWD Exceptions).

[132] Staff's Initial Brief at 78; Staff Ex. 4b at 6:18-21 to 7:1-2.

[133] PFD at 263.

[134] Staff's Initial Brief at 78; Tr. at 1429:22-25.

COVID-19 adjustment was approved this could serve as "future precedent whereby an adjusted year-based cost of service study filed in accordance with Commission rules and historical practice is essentially abandoned and replaced with a new cost of service study (or at least new billing determinants) shortly after the applicable test year."[135]

Overall, Staff supports the ALJs decision that SWEPCO should not be required to update its customer CCOSS to incorporate the impacts of the COVID-19 pandemic.

IX. FUNCTIONALIZATION AND COST ALLOCATION

B. Class Allocation

5. TCGA's Class Allocation Issue

The PFD correctly concludes that because TCGA has not submitted an alternative class allocation (or rate design) proposal to be considered in this proceeding, SWEPCO's customer class cost of service (CCOSS) should not be changed based on TCGA's criticisms.[136] TCGA excepts to the PFD's conclusion and states for the first time in its exceptions that it does not need to submit an alternative class allocation or rate design proposal but rather that the only required change would be to zero out the demands for the Cotton Gin class in certain class allocators.[137] As part of the basis for TCGA's exceptions for an alternative class allocation, TCGA notes that the PFD states that "[t]he evidence shows that TCGA is not served by an underground conduit, or primarily from secondary lines, and its vegetation management requirements are much less than those required by SWEPCO's northeast Texas customers."[138] The PFD continues and states that SWEPCO's CCOSS, or its rate design may be applied properly to the Cotton Gin class.

Staff agrees with the PFD that without an alternative class allocation or rate design as part of the record in this proceeding SWEPCO's CCOSS should not be changed.[139] Furthermore, Staff agrees with SWEPCO that TCGA's criticisms should be addressed through cost allocators and "a customer's unique circumstances are taken into account based on the customer's demand

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[135] PFD at 264.

[136] *Id.* at 287.

[137] Texas Cotton Ginners' Association's Exceptions to the Proposal for Decision at 6-7 (Oct. 7, 2021) (TCGA Exceptions).

[138] PFD at 284.

[139] *Id.* at 287.

when determining cost allocation for generation, transmission and distribution services."[140] Additionally, as noted by SWEPCO, allocation of rates based on system wide costs is consistent with the methodology approved in Docket No. 46449.[141] By focusing on underground conduits and vegetation management expense, TCGA is focusing on only certain cost items where the Cotton Gin class may have lower than average costs and ignoring those items where the Cotton Gin class might have higher than average costs, such as transmission costs, line transformers, or overhead conductors. Furthermore, TCGA's proposal to zero out the demands for the Cotton Gin class for certain allocators would potentially impact the allocation of many cost items beyond the specific ones identified by TCGA, such as certain general plant accounts, O&M expenses, and administrative and general expenses.[142] The PFD reached the correct conclusion that without an alternative class allocation or rate design as part of the record in this proceeding, TCGA's criticisms should not lead to changes in the rate design. However, Staff argues that SWEPCO's CCOSS is properly applied to the Cotton Gin class and that allocation of costs based on system wide rates is consistent with prior Commission precedent and that the PFD's Finding of Fact No. 251 should be rejected by the Commission.

TCGA also excepts to the number running calculations relative to the revenue increase distribution as shown in Schedule C to the PFD.[143] According to TCGA, in the number running calculations the 43.26% base rate increase cap was not reduced consistent with the percentage reduction in the base rate revenue increase as proposed in the PFD.[144] Specifically, TCGA states that its ultimate request is that the resulting rate increase for the Cotton Gin class is "no more than the lower of either the system average base rate increase or a rate increase no more than of 37.44%"[145] and that the ALJs erroneously determined that the Cotton Gin class rate increase of 32.84% was in the desirable range for the Cotton Gin class.[146] Essentially TCGA claims that because a lower revenue requirement was approved that SWEPCO's request in its rebuttal case,

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[140] SWEPCO Reply Brief at 107.

[141] *Id.*

[142] Number Running Workpapers, 51415 PFD Schedule B.xlsx (Aug. 30, 2021).

[143] TCGA Exceptions at 8.

[144] *Id.*

[145] *Id.*

[146] *Id.* at 8-9.

the rate increase applied to the Cotton Gin class should be reduced. However, the PFD approved SWEPCO's rebuttal revenue distribution which applied a 43% cap to three individual rate classes that were significantly below unity including the Cotton Gin class.[147] The 43% cap used in SWEPCO's rebuttal revenue distribution is based on prior Commission precedent.[148] Additionally, the PFD did not state that the cap should be scaled down if a lower revenue requirement was approved. Rate shock is properly evaluated based upon the total overall increase to customers within the class and not upon the relative increase the class may receive. Relative to customers in other classes and under Schedule C to the PFD, TCGA still receives a significant subsidy paid for by other rate classes which would increase if TCGA's exceptions were accepted by the Commission.[149]

Overall, unless Staff's proposal for a multi-step rate increase to move rates to cost over four years is adopted, TCGA's rate increase as noted in Schedule C should be accepted by the Commission, consistent with Staff's recommendation and prior precedent that a class' present revenues should be evaluated inclusive of TCRF and DCRF revenues when setting rates in this case.[150]

X. REVENUE DISTRIBUTION AND RATE DESIGN

B. Rate Design and Tariff Changes

1. Staff's Issues Regarding the GS Rate Schedule and Customer Migration

a. The GS Rate Schedule 50kW Maximum Demand

The PFD correctly decided that the Commission should reject SWEPCO's proposal to revise its General Services (GS) rate schedule to remove the provision that restricts availability of the rate schedule to customers with a maximum demand that does not exceed 50kW.[151] SWEPCO excepts to the PFD's decision disallowing removal of the 50kW demand cap stating that the new GS tariff proposal was designed with two options, a kWh (energy)-only option and

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[147] PFD at 294.

[148] *Id.* at 298-300.

[149] *Id.* at 300; Docket No. 46449, Proposal for Decision at 350.

[150] Commission Staff's Exceptions to the PFD at 11; Docket No. 46449, Order on Rehearing at Finding of Fact 314.

[151] PFD at 304.

a demand (kW)-based option, removing the 50kW maximum demand requirement and by rejecting this proposal, the PFD fundamentally changes the rate design.[152] SWEPCO also notes that its proposed revision to the GS tariff will lead to migration between classes that is normal customer behavior.[153] SWEPCO also stated that the PFD is inconsistent in its recommended rejection of SWEPCO's revision to the GS rate schedule and its recommendation that the Commission direct SWEPCO to address the broader issue of customer migration in SWEPCO's next base rate case.[154]

As explained by Staff witness Adrian Narvaez, SWEPCO's GS tariff proposal could lead to a migration of customers from the Lighting and Power (LP) Tariff to the GS tariff since the LP tariff would be less economical than the GS tariff.[155] Furthermore, Mr. Narvaez explains that "while it is normal to expect the number of customers taking service under a specific tariff to vary somewhat from year to year, structural tariff changes designed to encourage customer migration from tariffs that are less economical is a significant change that could drastically alter the cost of service of the two general services classes."[156] The PFD accurately notes that SWEPCO's proposal is a structural tariff change stating that "[u]nder SWEPCO's proposal, customer with higher demands that take service under the LP schedule, for example at 100kW, would now be able to migrate to the GS schedule even if there are no 'additions, removals, or changes' in the LP customers' loads."[157] Overall, the PFD appropriately agrees with Staff that SWEPCO's GS tariff proposal does not simply involve normal customer migration and SWEPCO's proposal should be rejected. Finally, the PFD's recommendation that the Commission direct SWEPCO to address the broader issue of customer migration in SWEPCO's next base rate case is consistent with the PFD's recommended rejection of SWEPCO's revision to the GS rate schedule because it seeks to address distortions caused by customer migration that affect SWEPCO' s ability to design rates that recover the cost to serve any particular class.[158]

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[152] SWEPCO's Exceptions to the PFD at 51.

[153] *Id.*

[154] *Id.*

[155] Staff Ex. 4, at 26:15-19, 27:17-20.

[156] *Id.* at 27:17-21.

[157] PFD at 304.

[158] *Id.* at 306.

XIV. CONCLUSION

Staff supports the PFD's recommendations on the accounting treatment for Dolet Hills, the removal of the NOLC ADFIT from rate base, as well as several additional issues. In addition, other parties' exceptions regarding the recommended ROE and revenue distribution only serve to emphasize the wisdom of Staff's positions on these issues.

Staff respectfully requests that the Commission adopt the positions set out in the foregoing.

CERTIFICATE OF SERVICE

I certify that, unless otherwise ordered by the presiding officer, notice of the filing of this document was provided to all parties of record via electronic mail on October 28, 2021, in accordance with the Order Suspending Rules, issued in Project No. 50664.

/s/ Robert Dakota Parish
Robert Dakota Parish